Service with a smile: A new growth engine for poor countries

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Services have long been the main source of growth in rich countries. This column argues that services are now the main source of growth in poor countries as well. It presents evidence that services may provide the easiest and fastest route out of poverty for many poor countries.

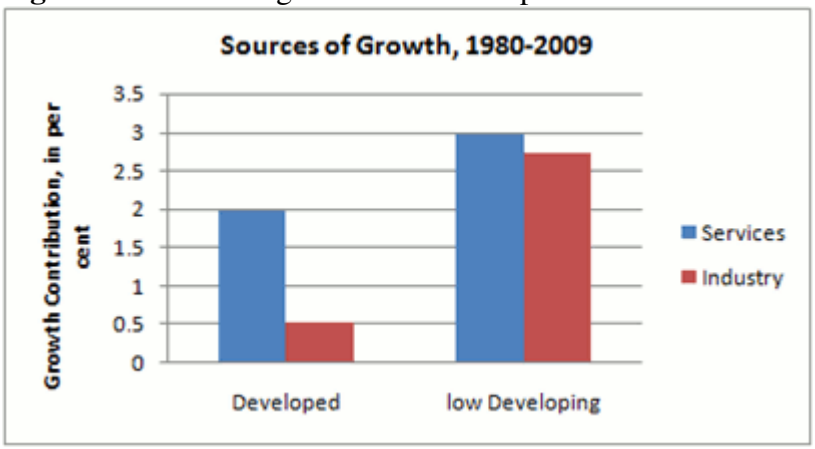
For more than 200 years, it was argued that economic development and growth was associated with growth of the labour-intensive manufacturing sector (Baumol 1967, Kaldor 1966, UNIDO 2009). Services were considered as menial, low-skilled, and low-innovation (McCredie and Bubner 2010). But today, services can be among the most dynamic sectors in an economy. The policy question is whether this is true even in poor countries.

There is evidence that services contribute more to GDP growth, job creation, and poverty reduction than industry in many developing countries (Ghani and Kharas 2010). Services now account for more than 75% of the global economy (45% in developing economies). Services are the fastest growing sector in global trade. The share of developing countries in world service exports increased from 14% in 1990 to 21% in 2008. The average growth of service exports from poor countries has exceeded that of rich countries during the last two decades. Their service exports are growing faster than goods exports. In brief, the globalisation of services has enabled developing countries to tap into a new, dynamic source of growth.

It is not surprising that services are expanding rapidly in upper middle-income developing countries. Their economies increasingly resemble those of rich countries where services have long dominated economic growth. This column, however, focuses on the contribution of services to poor countries defined as low-income and lower middle-income in the World Bank classification in 2009.

Figure 1 shows the composition of services and industry to GDP growth in the last thirty years for rich and poor countries. In both cases, the contribution of services to total growth is higher than industry's contribution. In poor countries, services (and industry) have contributed more to growth than in rich countries.

Figure 1. Sources of growth in rich and poor countries

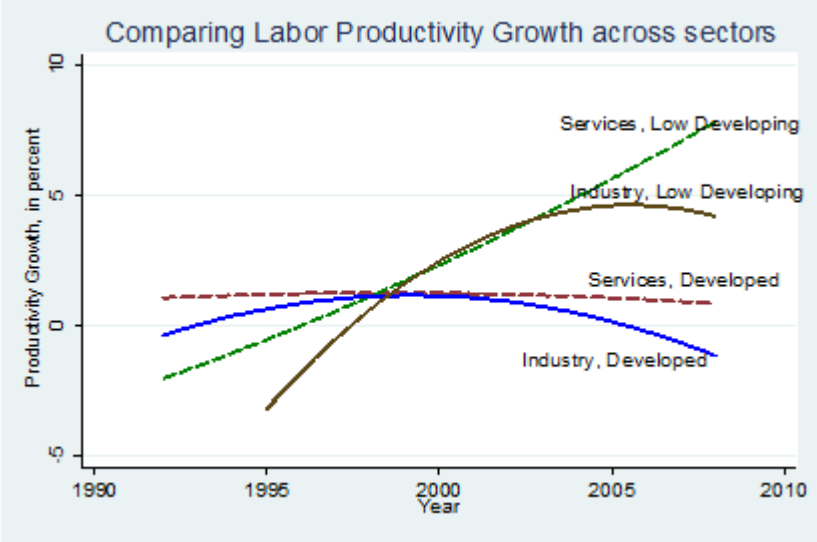


Source: Authors' calculation from World Development Indicators, World Bank.

Figure 2 shows that the rise in services' contribution to growth is linked to a rise in productivity growth in the sector. Labour productivity growth in rich countries has been higher in services than in industry, and it remains positive. That implies that the global

technology frontier for services is still shifting out, while that for industry has stagnated. At the same time, productivity growth in poor countries in services is accelerating and appears to have outstripped productivity growth in industry. In 58 out of 94 countries for which we have data, productivity growth in services exceeded that in industry.

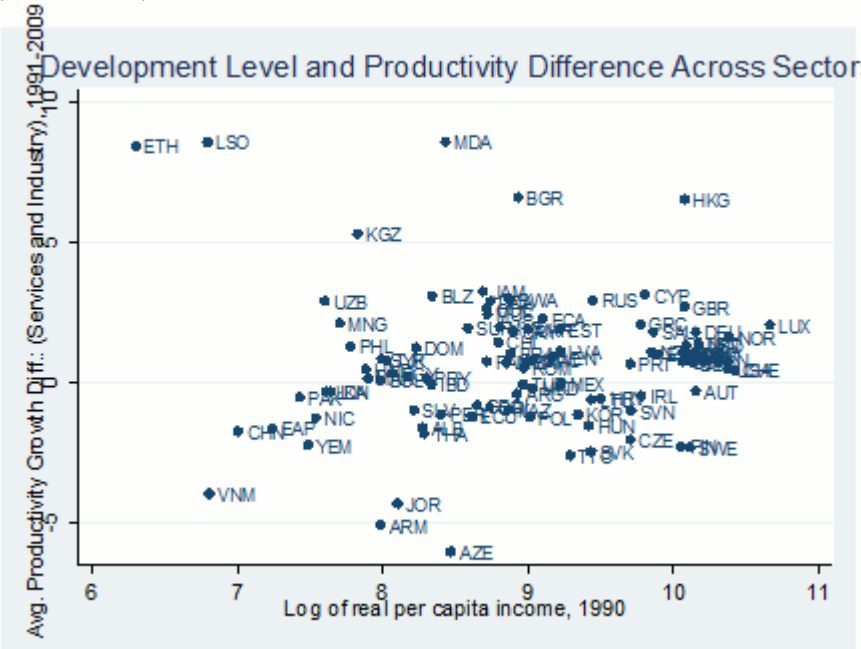
Figure 2. Comparing labour productivity across sectors



Source Authors' calculation based on World Development Indicators. Note: Labour productivity is calculated as the sector value added per employee. Line shown is the best-fit quadratic function.

Figure 3 plots the difference between average labour-productivity growth in services and industry against the log of real per capita incomes. There appears to be no tendency for this differential to be associated with per capita income levels. Poor countries like Ethiopia, Moldova, and Lesotho are just as likely to excel in services, compared to industry, as rich countries like Hong Kong and Bulgaria.

Figure 3. Differences in labour productivity growth across service and manufacturing sectors (1990-2009)



Source: Authors' own calculation from World Development Indicators.

Interpreting modern service productivity growth

Services can be divided into two broad categories – modern services and traditional services. Modern services, which are information communication technology (ICT) intensive, can be unbundled, disembodied, and splintered in a value chain just like goods (Bhagwati 1984). They can be electronically transported internationally through satellite and telecom networks. The other broad category of services is traditional services which are not ICT-intensive.

It is modern services that are developing rapidly thanks to the 3Ts (Ghani 2010): growing tradability, more sophisticated technology (including specialisation, scale economies and off-shoring) and reduced transport costs.

Tradability: Innovations in ICT have made modern services more tradable for all countries, but especially for poor countries. Of total services exports of $3.5 trillion in 2007, modern commercial services accounted for $1.73 trillion. India is the most famous example of a major modern service exporter, but during the last decade, some poor countries in Africa such as Rwanda, Swaziland and Burundi have experienced growth rates in aggregate service exports that are even higher than India's. For the period 1990-2009, poor countries' exports of modern commercial services have grown by 14.6% per year. Excluding India and China, the figure is still a respectable 9.1%.

Figure 4a shows that exports of services as a fraction of total value added has risen over time for both poor and rich countries. This ratio is higher for poor countries. Figure 4b shows that for both poor and rich countries, a growing fraction of total services trade is now accounted for by modern services.

Figure 4a. Tradability of services is higher for poor countries **(1990-2007)**

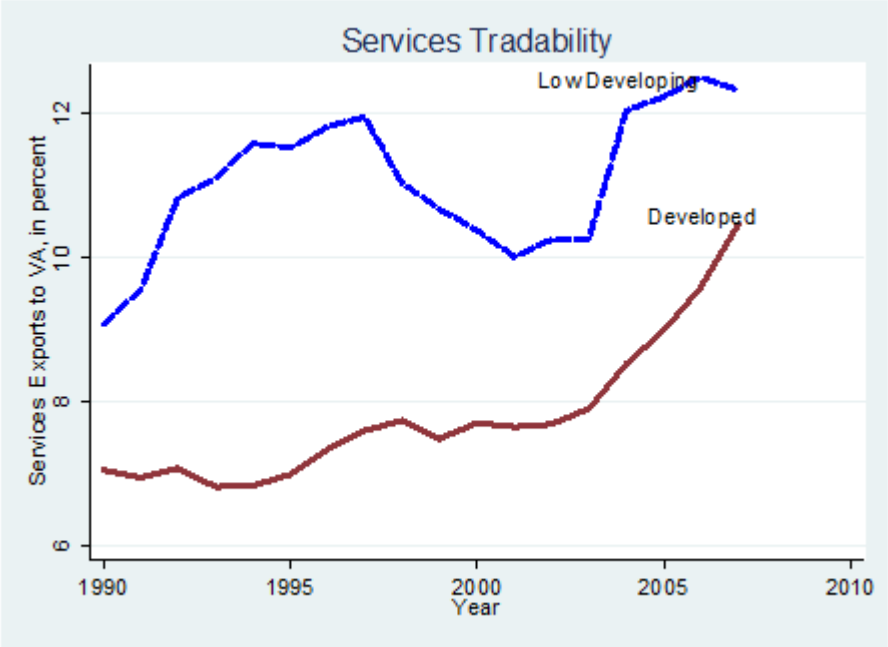
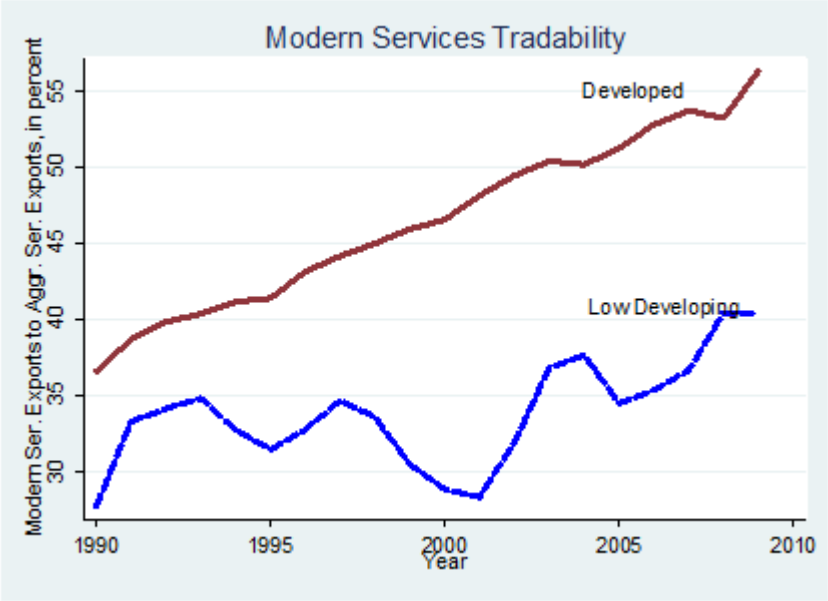
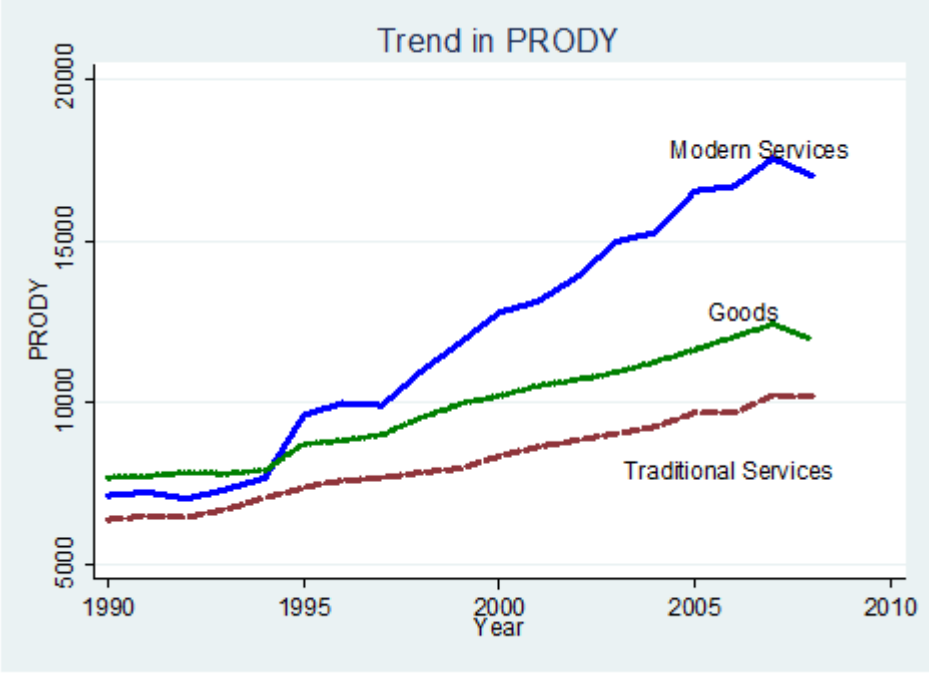


Figure 4b. Modern service exports are increasing from both poor and rich countries (1990-2007)



Technology: Modern service exports are becoming more technologically sophisticated. Using Hausmann's (2007) PRODY methodology, the growing sophistication in modern services compared to goods and traditional services is clear (Figure 5). In 1990, modern services had a PRODY that was 10% higher than traditional services, but about 8% lower than that of goods. By 2007, the PRODY for modern services was 70% higher than for traditional services, and 40% higher than for goods.

Figure 5. Trend in PRODY for services and goods



Source: Authors' calculation based on World Development Indicators

The intuition behind PRODY as an index of product sophistication is simple. If a product is only exported by rich countries, it must be because it is produced by sophisticated technology (for example, airplanes). Equally, if a product comprises a large share of a rich country's exports (compared to the overall world export share of that product), it must be because it is somehow more sophisticated in its technology. Thus, PRODY can grow because the income levels of the main exporting countries grows or because the revealed comparative advantage

(the weights) of countries grows.

Transport costs: Historically, service trade has been limited because it requires close proximity and face-to-face interaction between the buyer and the seller. Recent innovations in ICT have, however, rendered several previously non-tradable services tradable. Telephones and internets have contributed to global supply chains being extended into services, just as they have been extended into parts and components of manufactured goods. The cost of transporting services that could be digitized has fallen dramatically and services do not have to confront customs and other logistical barriers in poor countries.

Services trade have been studied using the same kind of gravity models as goods trade, and find that distance between countries dampens service trade just like for goods trade (Grunfeld and Moxnes 2003; Kimura and Lee 2006; Mirza and Nicoletti 2004; Shingal 2010; Kox and Lejour 2005; Lennon 2008; Head et al. 2008). This is perhaps surprising given that services can be easily transported internationally through satellite and telecom networks without customs and other logistical barriers, so the marginal cost of greater distance is negligible. But Head et al. confirm empirically that the impact of distance appears to be getting smaller over time, boosting services trade growth.

Conclusion

Can poor countries take advantage of the trend to disembodied services and services trade growth? The answer is yes. India has been a pioneer, but many other poor countries are finding it easier to generate productivity growth in services than in industry.

Although the same set of general non-distortionary policies is as important for modern services as for goods, specific strategies for services matter. Modern services need a strong telecommunications backbone and more advanced education (secondary and higher). Use of the internet, personal computers and telephone lines are all independently significant in service exports (Lennon 2006). Promoting foreign direct investment selectively in telecom sectors is now an active component of industrial policy in many developing countries. In India and the Philippines, industry associations have given service companies a unified voice and played an instrumental role in the policymaking process.

Globalisation of services provides many opportunities for late-developing countries to find niches where they can be successful. Taking advantage of these opportunities requires a government that energetically takes steps to accelerate services growth, through a variety of active policies. Services may provide the easiest and fastest route out of poverty for many poor countries.

Disclaimer: The views expressed here are those of the authors and not of any institutions they may belong to.

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